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In the Supreme Court of the United States

OCTOBER TERM, 1965

No. 922

KARL F. KNETSCH AND EVA FAY KNETSCH,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the Court of Claims (Pet. 1a-16a) is reported at 348 F. 2d 932.

JURISDICTION

The judgment of the Court of Claims was entered on July 16, 1965 (Pet. 1a, 16a), and petitioner's [1] motion for rehearing was denied on October 15, 1965.

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[1] Mrs. Knetsch is a party solely because she and her husband filed a joint income tax return for the year here in question. We refer to Mr. Knetsch as "petitioner."

By order dated January 13, 1966, the Chief Justice extended the time for filing a petition for a writ of certiorari to and including January 17, 1966. The petition for a writ of certiorari was filed on January 17, 1966. The jurisdiction of this Court is invoked under 28 U.S.C. 1255(1).

QUESTIONS PRESENTED

1. Whether the Court of Claims correctly held that petitioner's costs of a sham transaction were not deductible either as a loss on a transaction entered into for profit within the meaning of 1954 Code § 165(c)(2) or as an expense of maintaining property held for the production of income within the meaning of § 212(2).

2. Whether the lower court erred in denying petitioner's motion for leave to amend his complaint.

3. Whether the court below correctly held that petitioner was not entitled to a deduction in order to achieve equality with other taxpayers similarly situated.

STATUTES INVOLVED

Internal Revenue Code of 1954:

> SEC. 165. LOSSES.
>
> (a) *General Rule.*—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.
>
> * * * *

(c) *Limitation on Losses of Individuals.*—In the case of an individual, the deduction under subsection (a) shall be limited to—

* * * *

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; * * *

* * * *

(26 U.S.C. 165.)

SEC. 212. EXPENSES FOR PRODUCTION OF INCOME.

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

* * * *

(2) for the management, conservation, or maintenance of property held for the production of income; * * *

* * * *

(26 U.S.C. 212.)

STATEMENT

Most of the underlying facts in this case were previously before this Court in *Knetsch* v. *United States*, 364 U.S. 361 (Pet. 1a-2a).

On December 11, 1953, petitioner purchased from Sam Houston Life Insurance Company ten 30-year maturity deferred annuity savings bonds, each in the face amount of $400,000, and bearing interest at the rate of 2½ percent compounded annually. The total purchase price was $4,004,000. Petitioner gave the

company his check for only $4,000 and signed $4,000,000 of non-recourse notes for the balance, the notes bearing 3½ percent interest and being secured by the annuity bonds. Thereafter petitioner made annual "interest" payments to the insurance company and at about the same time each year "borrowed" from the insurance company the full increase in the cash value of the annuity savings bonds. The net result of these transactions was that the annuity policies were never worth more than $1,000. Petitioner surrendered the annuity bonds on December 27, 1956, offsetting the $4,308,000 cash value of the bonds against his $4,307,000 indebtedness, and receiving the $1,000 balance in cash. Because petitioner had paid "interest" at the rate of 3½ percent and earned interest at the rate of only 2½ percent, he had an out-of-pocket loss on the entire transaction of $137,315.

Petitioner claimed a deduction for his "interest" payments in 1953-1955, but the Commissioner disallowed these deductions. In *Knetsch* v. *United States*, 364 U.S. 361, 366, this Court upheld the Commissioner on the ground that the entire transaction was a sham with "nothing of substance to be realized by Knetsch * * * beyond a tax deduction" for the so-called "interest" payments.

Thereafter petitioner brought this suit, claiming the right to deduct in 1956, the year he surrendered the annuity contracts, his $137,000 out-of-pocket loss on the entire transaction. The Commissioner disallowed the deduction, and the Court of Claims granted summary judgment in favor of the government. The court stated that the transaction was not entered into

for profit, but rather was part of a scheme designed solely to obtain a tax deduction. Therefore, it held that petitioner's loss was not "incurred in any transaction entered into for profit" within the meaning of § 165(c)(2) of the 1954 Code, nor was it "an ordinary and necessary expense" for "the management, conservation, or maintenance of property held for the production of income" within the scope of § 212(2). The court also held that the Internal Revenue Service was not required to give petitioner a loss deduction in 1956, when he closed out the annuity transaction, merely because it had allowed those taxpayers who had relied to their detriment on erroneous letter rulings to deduct a portion of their "interest" payments, *i.e.*, to deduct that part of the "interest" payment equal to their out-of-pocket costs. Petitioner, the court found, was not seeking deductions for 1953-1955 when he made "interest" payments, but was asking for a loss deduction on the cancellation of his annuity in 1956. (Pet. 1a-4a; 364 U.S. at 362-364.)

ARGUMENT

The decision below is correct and there is no conflict of decisions warranting review by this Court.

1. The determination of the court below that petitioner did not enter into the annuity transaction with any intent to realize a profit apart from the tax benefits and that his out-of-pocket costs were thus not a loss deductible under § 165(c)(2) is clearly in accord with this Court's decision in *Knetsch* v. *United States*, 364 U.S. at 366. In that case the Court held

that the annuity transaction here in question was a sham from which petitioner stood to realize nothing of substance beyond the creation of a tax deduction. See also *Gregory* v. *Helvering*, 293 U.S. 465; *Gerstell* v. *Commissioner*, 319 F. 2d 131 (C.A. 3), certiorari denied, 375 U.S. 941. Similarly, in the absence of a profit motive petitioner's loss cannot qualify as an expense paid or incurred during the taxable year for the conservation or maintenance of property held for the production of income within the meaning of § 212 (2). *United States* v. *Gilmore*, 372 U.S. 39, 48.

Petitioner's argument (Pet. 9-10) that summary judgment is improper when motive is an ultimate fact is plainly inapplicable here where the facts of the transaction itself show that petitioner could not have entered into it for profit, and where, in addition, petitioner is collaterally estopped by the determination of that issue in the prior litigation. *Commissioner* v. *Sunnen*, 333 U.S. 591, 597-598, 601.

2. Petitioner's contention (Pet. 5-7) that the Court of Claims abused its discretion in refusing him leave to amend his complaint to claim a deduction for a theft loss is without merit. Where it is clear that an amendment would be futile, the court may properly deny leave to amend. See *Foman* v. *Davis*, 371 U.S. 178, 182; *Kinsley* v. *Markovic*, 333 F. 2d 684 (C.A. 4). Petitioner's requested amendment was patently without merit for at least two reasons. First, petitioner was barred by the statute of limitations from making the arguments contained in the amended complaint. No new claim for refund may be filed more than two years after payment of the tax or three

years after filing of the return, whichever is later. 1954 Code § 6511; *Real Estate Title Co.* v. *United States*, 309 U.S. 13, 17-18; *United States* v. *Garbutt Oil Co.*, 302 U.S. 528. This period had long since expired when petitioner in March 1965 filed his second claim for refund—the only one presenting the theft loss argument—with the IRS and asked the Court of Claims for leave to file an amended complaint.[2]

Second, it is clear that the allegations stated in the amendment do not state a claim for a theft loss deduction.[3] Even if, as petitioner alleges, he made payments to the insurance company in 1953-1955 only because an agent of the company fraudulently represented that the payments would be tax deductible, no such payments were made in 1956, the only year here in question. Moreover, petitioner nowhere alleges that the insurance company is insolvent or that he is otherwise prevented from recovering his money from it.

3. The Court of Claims also properly rejected petitioner's contention (Pet. 17-18) that although he was not entitled to a loss deduction under the substantive provisions of the Code, he was nevertheless entitled to such a deduction in order to achieve equality of treatment with other taxpayers similarly situated. The Service had given letter rulings to a number of

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[2] The 1956 taxes here in question were paid no later than January 1961; petitioner's original claim for refund was disallowed in July 1962 (R. 9). The record does not indicate that the second claim for refund was filed before March 1965 (R. 225).

[3] While petitioner asserts that three theories were stated in the amended complaint, he mentions only the theft loss ground in his petition for certiorari (Pet. 5, fn. 8).

taxpayers stating that "interest" payments on contracts similar to those purchased by petitioner would be deductible. The Service later revoked those rulings retroactively, but allowed taxpayers who had acted to their detriment in reliance on such rulings (whether or not issued to them) to deduct so much of the "interest" payments as did not exceed their out-of-pocket costs, *i.e.*, the Service allowed a deduction for that portion of the "interest" paid which exceeded the amount received as a "loan" (Pet. 15a; R. 267-280, 296).[4] Petitioner, however, did not request a deduction for his net out-of-pocket expenses in the years 1953-1955, but instead claimed a loss deduction for the year 1956 when he closed out the transaction (Pet. 15a-16a). Certainly where, as here, there is no indication that any taxpayer has been given a deduction denied to this taxpayer, the court below did not abuse its discretion in refusing to grant petitioner the right to examine Internal Revenue Service of-

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[4] The record demonstrates that this was the treatment given to Mr. R.C. Salley, president of the Sam Houston Life Insurance Company, whose private ruling petitioner claims to have seen and relied upon. The Service's letter of June 29, 1954, notifying Salley of the revocation of the prior erroneous ruling concluded (R. 220):

> Therefore, deduction by you of the so-called interest for the period August 1, 1952 (the date of the original ruling) to November 23, 1953 (the date you were advised that the ruling could no longer be relied upon) will not be disallowed to the extent that such disallowance would result in a detriment to you. The amount of any detriment which you may have incurred will be determined by the examining officer upon examination of your return for the years involved.

ficials in an attempt to determine whether any other taxpayers had been treated differently than petitioner.

Moreover, in making his 1953-1955 "interest" payments petitioner did not rely upon an effective ruling. Eighteen days before petitioner contracted for his first annuity, the Service notified R.C. Salley, president of the Sam Houston Life Insurance Company (who had previously received a ruling that such "interest" payments were deductible in full) that consideration was being given to revoking his ruling, that "no further rulings will be issued approving the type of transaction involved," and that it could not advise him as to the extent that it would recognize reliance on the ruling by him or others (R. 3, 219). Thus, even though petitioner may have relied upon the ruling to Salley in entering into the annuity transaction, his loss was not attributable to the action of the Service, but to the insurance company's failure to inform him of the ruling's doubtful status at the time he signed the contracts. The Service made no representations to petitioner when it issued the original ruling to Salley, and it had no duty to notify petitioner or anyone else when it informed Salley that it was correcting its position. If the insurance company made a material misrepresentation and petitioner voluntarily chose not to pursue his remedies against the company, he can hardly be entitled to claim that he has involuntarily sustained a deductible loss. *Juniper Investment Co.* v. *United States*, 338 F. 2d 356 (Ct. Cl.).[5]

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[5] Moreover, even if petitioner had been entitled to rely on the Salley ruling, two of the three "interest" payments which

Contrary to petitioner's contentions, there are no conflicting decisions by this or any other appellate court. Petitioner's citations (Pet. 18) do not support his claim to equal though erroneous tax treatment. The citation to the concurring opinion in *United States* v. *Kaiser*, 363 U.S. 299, 308, involving the taxability of strike benefits, is merely to Mr. Justice Frankfurter's restatement of the taxpayer's argument (which he found to be inapplicable in any event). Nor is *Dixon* v. *United States*, 381 U.S. 68, authority for petitioner's position. Indeed, that decision upheld the Commissioner's discretionary authority under Section 7805(b) of the Internal Revenue Code of 1954 to distinguish between different taxpayers who had relied upon an erroneous published ruling by revoking the ruling retroactively as to one group but only prospectively as to the other. Petitioner's citation (381 U.S., p. 77, fn. 9) is again to the Court's restatement of an argument which had been made by the taxpayer but which the Court found inapplicable. Finally, petitioner's reliance (Pet. 5, 18) upon *International Business Machines Corp.* v. *United States*, 343 F. 2d 914 (Ct. Cl.), certiorari denied, January 31, 1966, is misplaced. That case, which was decided by the same court that decided the instant case, "was based on the court's evaluation of the particular cir-

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caused petitioner's out-of-pocket loss on the transaction were made after official publication of Rev. Rul. 54-94, 1954-1 Cum. Bull. 53, in March, 1954, stating that such "interest" payments were non-deductible. Since petitioner was free to cancel the annuity contracts at will (R. 221), in no event can he claim that he made any payment after March, 1954, in reliance on the prior letter ruling to Salley.

cumstances in that case" (Pet. 14a, fn. 14).[6] See also *Bookwalter* v. *Brecklein* (C.A. 8), decided March 1, 1966.

CONCLUSION

For the foregoing reasons the petition for a writ of certiorari should be denied.

Respectfully submitted.

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MARCH, 1966.

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[6] Nor is there any merit to petitioner's contention (Pet. 19) that the government was equitably estopped from denying the deduction because petitioner relied upon letter rulings issued to other taxpayers. In addition to the reasons given above (pp. 7-9, *supra*), it is well established that "The doctrine of equitable estoppel is not a bar to the correction by the Commissioner of a mistake of law." *Automobile Club* v. *Commissioner*, 353 U.S. 180, 183; see also *Dixon* v. *United States*, 381 U.S. 68, 72-73, 76.

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